Office of Chief Counsel
Internal Revenue Service
memorandum
CC:LM:HMT:CIN:2:POSTF-126697-02
GRShuler

date: Jun 10 2002

to: Carol T. Brown, Team Coordinator, Team 1186

from: Associate Area Counsel (Large and Mid-Size Business)
Cincinnati, Ohio CC:LM:HMT:2

subject: **Buyout Fee Paid by [redacted]**

This memorandum responds to your request for assistance dated May 9, 2002. This memorandum should not be cited as precedent.

You have requested assistance in ascertaining the proper treatment of a "buyout fee." The taxpayer has submitted an affirmative issue to the Team Coordinator requesting a deduction of a payment in the amount of $[redacted] that it made to an entity in [redacted] to cancel an obligation under an agreement. Based on the information you provided, the buyout fee must be capitalized and should be amortized over the remaining term of the agreement, as amended.

ISSUE

Whether amounts paid to relieve the taxpayer of certain long-term payment obligations in an agreement may be deducted when the payment is made currently with the execution of a second agreement containing substantial similar provisions of the first agreement in a modified form.

CONCLUSION

The buyout fee is an expense connected to the integrated events of deletion of one provision from the first agreement and execution of the second agreement modifying the terms of the first agreement. Accordingly, the expense must be capitalized as a cost of the taxpayer's realization of future benefits provided in the second agreement.

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FACTS

The facts as we understand them follow. Prior to [redacted], [redacted] and [redacted] were parties to an agreement entitled "[redacted]" ("the [redacted]"). Under the terms of the [redacted], [redacted] remained liable under certain long-term real estate lease obligations assumed by [redacted]. [redacted] also was required to pay [redacted] an annual fee for these liabilities, calculated as a percentage of the remaining gross obligation amount. [redacted] also agreed to be primarily liable and to indemnify [redacted] for any and all costs and obligations related to [redacted]'s liabilities.

In [redacted], [redacted], Inc. ("[redacted]") acquired [redacted]. [redacted] assumed some real property leases that required [redacted] to continue its obligations under the lease agreements. As part of the acquisition, [redacted] agreed to continue the [redacted] and make the annual payments to [redacted].

On [redacted], [redacted], [redacted] Inc. ("[redacted]") and [redacted] executed an agreement entitled "[redacted]" ("the [redacted]"). Pursuant to the [redacted], [redacted] made a one-time payment to [redacted] in the amount of $[redacted] in exchange for a termination of its obligation to pay future annual payments to [redacted]. The parties calculated the amount by applying an [redacted]% present value to the projected annual payments through [redacted].[1] Despite making this payment, in accordance with execution of the newer agreement, [redacted] and [redacted] remained primary obligors and agreed to indemnify [redacted] for any and all costs and obligations related to [redacted]'s liabilities.

As part of a proceeding under Bankruptcy Code Chapter 11, [redacted] and [redacted] entered into an agreement entitled "[redacted]" dated [redacted] ("the [redacted]"). Pursuant to the [redacted], [redacted] transferred its non-real estate operations to [redacted]. The reorganization was a taxable transaction pursuant to I.R.C. § 1060. As part of the reorganization, [redacted] assumed the real property leases. The lease obligations were transferred to [redacted] prior to the distribution of [redacted] stock to shareholders of [redacted]. [redacted] did not reimburse [redacted] for any portion of the buyout fee that it paid to [redacted].

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[1] The [redacted] expires on [redacted]. However, annual payments required under the agreement are not significant after [redacted].

LEGAL ANALYSIS

I.R.C. § 162(a) permits a taxpayer to deduct ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. An expense is ordinary if it bears a reasonably proximate relationship to the operation of the taxpayer's business. Deputy v. Du Pont, 308 U.S. 488, 495-496 (1940). An expense is necessary if it is helpful and appropriate in promoting and maintaining the taxpayer's business. Carbine v. Commissioner, 83 T.C. 356, 363 (1984), aff'd, 777 F.2d 662 (11th Cir. 1985).

A business expense deduction which might be deductible under section 162 must be capitalized when that amount must be charged to a capital account. I.R.C. § 263(a); Treas. Reg. § 1.263(a)-1(a). If a cost is a capital expenditure, the capitalization rules of section 263 take precedence over the deduction rules of section 162, thereby preventing capital expenditures from being deducted currently under section 162. Commissioner v. Idaho Power Co., 418 U.S. 1, 17 (1974).

Expenditures made to protect or preserve a taxpayer's business are deductible as business expenses if they do not result in the acquisition of a capital asset. First Nat'l Bank v. Commissioner, 35 B.T.A. 876 (1937), acq., 1937-1 C.B. 9. However, expenditures which secure a right to conduct a certain business such as a franchise, license, lease or approval of a regulatory agency are capital expenditures under section 263. See, e.g., American Stores Co. v. Commissioner, 114 T.C. 458 (2000)(retail food and drug corporation had to capitalize and could not currently deduct legal fees incurred in defending State of California's antitrust suit arising from grocery chain's acquisition.)

The Supreme Court has held that an expenditure must be capitalized if it creates a separate and distinct asset. Commissioner v. Lincoln Sav. and Loan Ass'n, 403 U.S. 345, 354 (1971). The Supreme Court has also held that an expenditure must be capitalized if it provides a significant long-term benefit to the taxpayer. INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). The primary purpose for making an expenditure does not determine whether an expenditure is a business expense or capital expenditure. Woodward v. Commissioner, 397 U.S. 572, 577 (1970). The true test of current deductibility depends on the duration and extent of benefits realized by the taxpayer, and where expenses relate more to a permanent betterment than to the current tax year, those expenses must be capitalized. See United States v. Gilmore, 372 U.S. 39 (1963)(In determining the nature of expenses, the Tax Court rejected a test that looked to the consequences of the taxpayer's litigation, and did not even consider the taxpayer's motives or purposes in the defense litigation, but rather examined the origin and character of the legal claim against the taxpayer.)

Despite the descriptive nature of the preceding statutory and judicial tests, the actual determination of whether an amount is a capital expenditure depends on the circumstances of each particular case.

In your case, [redacted] made a lump sum payment to [redacted] to be relieved from its obligation under the [redacted] to pay future annual payments to [redacted]. This payment was made in accordance with the parties' [redacted]. Through execution of the [redacted], [redacted] reaffirmed its obligation to indemnify [redacted] for any and all costs and obligations related to [redacted]'s liabilities. [redacted] also remained a primary obligor for all other lease liabilities.

Apparently, [redacted] believes that after the [redacted] it remained only secondarily liable for the lease liabilities. However, the [redacted] provides that [redacted] and [redacted] are jointly and severally liable. In addition, a party can assign its obligations under [redacted] only with the consent of [redacted]. No such consent was obtained in this instance. Nevertheless, our analysis and opinion do not turn on whether [redacted] was primarily or secondarily liable for the lease liabilities.

Where a lessee pays a lessor an amount to terminate a lease, and no subsequent lease or agreement is entered into by the parties, the termination fee is clearly deductible in the year incurred, as there is no possibility that the lessee will realize significant future benefits beyond the current taxable year. See, e.g., C. Ludwig Baumann & Co. v. Commissioner, 2 T.C.M. (CCH) 188 (1943); Hall & Ruckel, Inc. v. Commissioner, 1 T.C.M. (CCH) 177 (1942); Denholm & McKay Co. v. Commissioner, 2 B.T.A. 444 (1925), acq., 1925-2 C.B. 2 (1925); Rev. Rul 69-511, 1969-2 C.B. 24. The rationale underlying this principle of law is that the payments are made to terminate a lease and not made to produce future income. Instead they reflect costs incurred and damages paid in order to be released from an existing unprofitable agreement. See Cassatt v. Commissioner, 137 F.2d 745, 748-749 (3d Cir. 1943), aff'g 47 B.T.A. 400 (1942).

In your case, the [redacted] was effectively canceled. However, the same parties immediately entered into the [redacted] covering the same properties and the same period of time. The cancellation of the first agreement was expressly conditioned on the execution of the second agreement. These are integrated events that should not be viewed in isolation. The [redacted] states that it is being executed to modify (not extinguish) [redacted]'s obligations under the previous agreement. Specifically, the obligation to periodically pay a guarantee fee, previously contained in Section [redacted] of the [redacted], is deleted. The other substantive obligations of the parties remained unchanged. [redacted], as well as [redacted], continued to be a primary obligor with respect to all other obligations and liabilities under the [redacted].

In substance, the [redacted] was not canceled, but continues in modified form. Any costs incurred to modify the [redacted] are not currently deductible but rather are costs of continuing the [redacted] in modified form. See, e.g., U.S. Bancorp v. Commissioner, 111 T.C. 231 (1998). The cost of modifying the [redacted] and entering into the [redacted] is not merely an isolated expense. See LTR 9607016 (Nov. 20, 1995). The obligation to pay the buyout fee is properly characterized as a cost of [redacted]'s realization of future benefits provided for in the [redacted]. Rather than make annual payments throughout the duration of the [redacted], [redacted] agreed to make a one-time lump sum discounted payment. The one-time lump sum payment provides a significant long-term benefit to [redacted]. Accordingly, the buyout expenses should be amortized over the remaining term of the [redacted].

SUMMARY

The guarantee buyout fee that [redacted] paid to [redacted] is an expense associated with the deletion of one provision of the [redacted]. Because [redacted] will realize significant future benefits beyond the current taxable year, the expenditure must be capitalized over the remaining term of the [redacted].

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum is also subject to post-review by the Office of Chief Counsel, under CCDM (35)3(19)4. We will inform you of any modification of this advice.

Please contact Senior Attorney Gary R. Shuler, Jr. at (513) 263-4894, if you have any questions or need additional assistance.

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By:______________________________
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